FedFin Daily Briefing

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Fed Study: Banking Rules, System Pass COVID's Stress Test

Stating not unreasonably that the pandemic provides the first stress test of the post-2008 crisis, a massive new Federal Reserve staff study finds that U.S. banks were well-insulated from risk but did not use their resources to ensure ongoing macroeconomic activity in part because the PPP, credit-line drawdowns, nonbank lending, and reduced demand alleviated the need for additional commitments. Any credit crunch was due to broader macro factors, not bank weakness or even capital-buffer retention. U.S. banks were also considerably stronger through this crisis due in part to trading activities that no longer posed the risks associated with proprietary trading. Interestingly, CDS spreads did not vary in relation to relative bank capitalization, suggesting to the authors that the market does not view regulatory capital as predictive of bank weakness independent of macro factors.

In addition, the study finds that the post-2008 capital construct withstood stress well although market-risk and credit-valuation-adjustment were procyclical until regulators suspended certain requirements. GSIB capital requirements were remarkably uniform across jurisdictions and provided a vital safeguard for a financial system under acute stress. Although nations that triggered their counter-cyclical capital buffers before COVID released them quickly, CCyBs were inconsistently applied and largely so small where they did apply as to have little impact. However, the U.S. essentially deployed a CCyB by virtue of all its temporary capital exemptions, suggesting to the authors that dynamic capital requirements were deployed to good effect. As has been frequently noted, banks were also reluctant to use their buffers, action the paper suggests may be due to their desire to preserve capital-distribution capacity even under acute stress. Fed liquidity facilities generally made banks still more liquid rather than being necessary to ensure bank liquidity under stress because rules ensured that large banks were sufficiently liquid ahead of the pandemic.

In addition to ratifying the overall post-2008 bank framework, the paper makes a number of policy recommendations. These include not only studying why buffers were undrawn, but also revising CCyBs so that they are triggered by financial vulnerabilities, not the credit/GDP ratio in global rules (see FSM Report **CAPITAL213**). Buffer drawdowns appear to be a key forward-looking policy objective despite the findings noted above because, as the authors note, the next time around Congress and the Fed may not step in to the extent they did last March and April. A detailed review of the Fed's COVID backstop facilities also provides a discussion of how best to design these in future, noting that widespread bank use demonstrates that institutions will use Fed backstops without fear of stigma if publicly encouraged to do so.

Gillibrand, AOC Press for Postal Banking Pilot

Pursuing a goal also endorsed by President Biden during his campaign, Congressional Democrats including Sen. Gillibrand (D-NY) and Rep. Ocasio-Cortez (D-NY) late yesterday demanded that funds for a postal banking pilot be included in the FY22 appropriations package. Abandoning the authorization route pursued by Sen. Gillibrand in the past (see FSM Report **POSTAL9**), they call for appropriations language directing USPS in collaboration with Treasury and/or the Fed to carry out pilot programs in at least five urban zip codes and five rural zip codes expanding financial services offered at these post offices to include surcharge-free ATMs, wire transfers, check cashing, and bill payment to the fullest extent permitted under current law. The proposed appropriation is $6 million, a small sum almost certain to be insufficient for so ambitious a pilot but perhaps also small enough to avoid much controversy. Rep. Ocasio-Cortez could also pursue this appropriation as an earmark should she choose to do so.

Basel: Near-Term Work Focused on COVID, Crypto, Climate

The Basel Committee today published its work program and strategic priorities for 2021-22, laying out in general terms its work to support recovery and prepare for future risks. Basel thus plans a report on initial lessons learned from the COVID crisis this summer, with updates to follow. Global regulators will move forward also to assess the impact of digitalization and disintermediation of finance on banks' business models and the banking system; no timing is given. Basel also intends to finalize its outstanding initiatives on the prudential treatment of crypto-asset exposures and on disclosure requirements for market risk and sovereign exposures. The impact of an extended period of low interest rates on banks is also being assessed, and work on the assessment, measurement, and mitigation of climate-related financial risks continues. Additional efforts to strengthen supervision will also advance focusing on the use of AI/ML, data and technology governance, cybersecurity, and leveraged lending and CLOs.

Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing info@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about *GSE Activity Reports*, click here.

- **LIBOR5:** Following Fed agreement earlier this year that federal legislation is needed (see Client Report FEDERALRESERVE61), the HFSC Capital Markets Subcommittee today laid the groundwork for rapid introduction and action on Chairman Sherman's draft bill.

- **ILC16:** As anticipated, HFSC Democrats today continued their attack on non-traditional bank charters, with Chairwoman Waters (D-CA) pushing for no new ILC approvals and revoking the OCC's special-purpose charters.

- **GSE-041421**: A new study from the Federal Reserve Bank of New York contradicts many assertions that COVID's mortgage-market mania disadvantages first-time homeowners.

- **INFRASTRUCTURE7**: Sen. Joe Manchin (D-WV) recently reiterated that he believes an "infrastructure bank" would be an appealing way to fund significant U.S. investment without the direct cost associated with President Biden's plan.

- **GSE-040621:** Just to be sure servicers got the message sent last week that the CFPB has them in its crosshairs, the agency yesterday proposed sweeping changes to provide far-reaching foreclosure protections on all forborne or delinquent mortgages, not just those subject to the statutory protection afforded federal loans.

- **AI:** Advancing their efforts to ensure "responsible innovation," federal agencies have taken an initial, cautious step into assessing the prudential, compliance, risk-management, and fairness implications of artificial intelligence (AI) and machine learning (ML).

- **HEDGE59:** The stunning collapse of the leveraged family office, Archegos, and its impact on the financial system has renewed calls for an array of regulatory initiatives.

- **REFORM204:** Following yesterday's HFSC session (see Client Report **REFORM203**), Secretary Yellen and Chairman Powell today faced Senate Banking and, as before, a raft of questions with little to do with the hearing's ostensible focus on CARES Act programs.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

- **REFORM203:** At today's HFSC hearing on pandemic-relief programs, Members asked also about key financial-policy questions.
- **GSE-032321:** Last week, we analyzed a Federal Reserve study showing that unemployment is still inexorably linked to mortgage-default risk.
- **GSE-032221:** As we predicted, federal banking agencies didn't back down: the SLR exemption for central-bank reserves and Treasuries is no more as of April 1.
- **GREEN7:** Today's Senate Banking Committee hearing on climate risk made it clear that the partisan divide evident earlier this week on housing (see Client Report **MORTGAGE119**) and much else extends to what financial regulators should do about climate risk.
- **GREEN6:** Reflecting views of the Biden Administration and those of its nominee to chair the SEC, Acting Chair Allison Herren Lee is requesting public views ahead of more formal proposals revising the climate-risk disclosures to be required of publicly registered companies.
- **GSE-031721:** As our in-depth report makes clear, the Senate Banking (and Housing!) Committee's hearing yesterday showed the wide partisan chasm between what Democrats and Republicans want of the GSEs.
- **MORTGAGE119:** Reflecting Chairman Brown's (D-OH) prioritization of the "housing" jurisdiction under Senate Banking, the panel's hearing today addressed not only GSE reform, but a sweeping range of rental and affordable-housing considerations in concert with lending discrimination and housing finance.
- **UDAP7:** Continuing the quick reversal of numerous Trump-era policies, the CFPB has ended a controversial policy statement providing consumer-finance companies with considerable protection from assertions of abusive acts or practices.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com